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C O N F I D E N T I A L CARACAS 000669

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TREASURY FOR OASIA - SIGNORELLI
NSC FOR SHANNON AND BARTON
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E.O. 12958: DECL: 03/04/2015
TAGS: ECON EFIN PGOV VE
SUBJECT: VENEZUELA DEVALUES TO KEEP THE SPENDING MACHINE RUNNING

REF: CARACAS 578

Classified By: Economic Counselor Richard M. Sanders. Reason: 1.4(b) and (d).

Summary

¶1. (C) The GOV has announced announced the devaluation of the bolivar from 1920 to 2150 bolivars per dollar. The rise will mean that the GOV will have more local currency at hand to continue its highly aggressive spending policies, which have proven to be so politically popular. With high oil prices underpinning the economy, the impact on internal prices of the decision is, for the time being, likely to be tolerable, and the GOV should be able to keep to its goal of goal of 15 pct inflation for 2005. It is, however, already looking at some price increases at the highly popular state-run (and subsidized) discount food chain, Mercal. End summary.

New Rate Announced

¶2. (U) On March 2, the Central Bank and the Finance Ministry announced that the exchange rate, currently fixed at 1920 bolivars per dollar, would be changed to 2150 bolivars per dollar, a 10.7 pct devaluation. (Venezuela has had a fixed exchange rate since February 6, 2003, when it was imposed during the general strike which had shut down exports of Venezuela's principal foreign exchange earner, petroleum. Initially fixed at 1600 bolivars per dollar, the rate was changed to 1920 bolivars per dollar on February 9, 2004.) The quasi-legal parallel rate, which had been heading upward in recent days in expectation of an announcement, now stands at 2857 bolivars per dollar, 24.8 pct higher than the official rate, a relatively narrow spread. Finance Minister Nelson Merentes suggested that the impact of the devaluation on inflation would be minimal, while Vice President Jose Vicente Rangel would spoke in general terms of "highly satisfactory compensating effects" that the decision would bring.

One Economist's View

¶3. (C) Alejandro Grisanti, formerly chief economist for Spanish-owned Banco de Venezuela, now an independent consultant, told econcouns that the devaluation was driven by the GOV's desire for more cash to maintain its highly expansionary spending policies. He said that the devaluation would allow it to expend an additional 8.8 trillion bolivars (USD 4.5 billion). (Note: the GOV would access the money in two ways, by being able to convert dollar earnings from state oil corporation PDVSA at the new rate, and by pressing the Central Bank to remit to it more bolivars as earnings on the foreign exchange it holds. End note.) Admittedly, Grisanti went on, this would result in a jump in inflation of as much as 3 pct. Nonetheless, he thought that from a purely political calculus, the GOV had made the right decision. Having to cut back on its welfare programs, which are concentrated in the lowest income sectors, would probably be more damaging to its popularity than inflation, which is diffused among the whole population. Unemployment, although dropping, remains high, and for many these welfare programs, (such as "scholarships" for presumed high school or college studies) are their only form of income. Even if inflation means the recipients buy less, these transfer payments are still much better than nothing for them.

¶4. (C) Grisanti suggested that the timing of the announcement had been affected by the relatively low inflation numbers which the year to date has brought. Even with the price hikes which will be generated by the devaluation, inflation may well yet come under the 15 pct which Planning Minister Jorge Giordani has predicted. Grisanti thought the next devaluation might not come until

the end of the year. He saw inflation continuing on its downward trend, reserves staying strong, and the GOV able to maintain high levels of spending through 2006, all sustained

by high oil prices. This is a classic Venezuelan story, he added, with the final chapter being a brutal adjustment "when the model stops working" once oil prices finally drop.

A Key Price Rise in the Works Anyway

¶5. (U) Even ahead of the devaluation, news stories in major Caracas dailies suggested that prices would rise at the massive state-run "Mercal" chain of stores which sell staple foodstuffs at deep discounts. (The Mercal program, aimed at low income Venezuelans, is one of the GOV's most popular programs, see reftel.) Mercal President Jorge Luis Rodriguez bemoaned increases in costs which the (highly subsidized) chain most face) in transportation, services, and salaries. He said that he hoped that any price increase would be below the predicted 15 pct inflation, and thus would conserve the purchasing power of its customers. Any generalized price increase will require approval by President Chavez. (Comment: Bolivars obtained by devaluation may instead go to further subsidies to keep Mercal prices down, but, given that much of Mercal's inventory is imported, the devaluation will further aggravate its fiscal situation. End comment.)

Comment: A Devaluation Foretold

¶6. (C) The GOV's 2005 budget had explicitly assumed an exchange rate of 2150 bolivars per dollar, so this devaluation is not a surprise. It had initially been expected at the beginning of the New Year's (the traditional time for such announcements, during the many periods in which Venezuela has had a fixed exchange rate), but the GOV held off, many analysts believed, to keep prices down for a few months in order to assure that the 15 pct inflation target would be met this year. Inflation, while relatively high in January (1.9 pct,) came in very low in February (0.17 pct) making this strategy workable. We agree with Grisanti's suggestion that maintaining the various social "missions" has become more important to the Chavez government's popularity than avoiding a bump in inflation) on a downward track anyway. We expect that this expansive fiscal and with it monetary policy will continue as long as oil revenue remains abundant.
Brownfield

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